

Guest Speaker

On Thinking

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"Where all men think alike, no one thinks very much."

—Walter Lippmann

Thinking, good thinking that is, is a lonely sport.¹ This may explain why so many of us do it so poorly. Good thinking is also an inefficient process: It takes a lot of thinking to come up with those few good, new ideas that are clearly worth thinking about—ideas that can be exploited in the marketplace. Particularly, as Seldon so accurately noted in 1912, "Most coming events cast their shadows before, and it is on this that intelligent speculation must be based."²

At the heart of the thinking process is the need to anticipate change correctly, and on a timely basis. Investment thinkers must develop for themselves a model, or systematic perception, as to how markets really work. Those believing strongly in the efficient market hypothesis are, of course, relieved of such undertakings. However, as is becoming increasingly clear, portfolio theory does not fully explain security price movements, either here or abroad, or tell us too much about how to achieve better-than-average performance.

Most practitioners of active money management need to improve their thinking procedures. I hope these ruminations will help, but they cannot substitute for one's own formulation of new ideas upon which to build investment success.

Thinking

How we think significantly affects our ability to make good decisions. Most of us have an instinctive, often unconscious, tendency to engage in linear extrapolation, extending present

trends uncritically into the future. Often coupled with this human failing is a tendency to stick to our original course of action, seeking out information that reinforces the existing—comfortable—point of view.

Our reluctance to consider new information with an open mind makes it hard to recognize the flaws in our old operating premises. Instead, we tend to develop a "defensive" interpretation of new developments, and this cripples our capacity for making good judgments about the future. Investors must appreciate that, while there is a pattern to events, no pattern is perpetual. The more widely-held the belief in the persistence of a current trend, the less likely it is to continue.

Investors are often too heavily committed to the configuration of trends already discerned. But the comfort afforded by projecting existing conditions into the future is imaginary. In fact, once a pattern of expectation is taken for granted, its likelihood should be questioned all the more. Circumstances change faster than are commonly recognized. At the same time, the important trend-changing events tend to be underestimated during their early stages of development. Put another way, investors must keep in focus that it is the conventional forecast that is imbedded in today's price, not the future as it will necessarily turn out to be.

It is the difference between expectations and reality that changes people's perceptions about the future and moves stock prices accordingly. That is why the important question to think about is whether conditions are changing for the better or worse relative to expectations, and not whether they are currently good or bad. The process can be made more efficient by focusing on those factors most critical to the decision at hand—those few elements that account for the greatest part of the situation or even the one factor upon which the decision may turn. One must conquer the urge to learn everything about

some new development or unexpected turn of events. A sharp distinction must constantly be made between the facts needed to form a foundation for new action and those that merely keep one generally informed.

Thinking on the Margin

As all of us were taught, but most of us have long since forgotten, economic change occurs at the margin, where the action takes place. According to Jude Wanniski, individuals who can think on the margin always have an advantage over those who cannot.³ Unfortunately, only few of us are capable of thinking clearly, and acting effectively, on the margin. As history has taught us, most of the time, most of the crowd moves long after the optimum time to have moved is passed. So it is with investment trends, which start with the belief of a few and end with the conviction of the many. Dick Stoken put it this way some years ago:

Because human psychology is slow to change, a broad economic move usually occurs in three stages. The first stage begins when some unexpected event shatters an overdone psychological environment. Yet, while some people respond immediately to this new lesson, most people, as they find it outside their past experience, do not believe it. They need more evidence—that is, a second stage. Typically, the majority become convinced during the second stage and therefore the psychological background changes. People begin to act differently, and their behavior soon affects the performance of the economy.⁴

Perhaps T. Rowe Price, a student of wavelike movements in the marketplace, said it best:

It is better to be early than late in recognizing the passing of one era and the waning of old favorites, and the advent of a new era, offering

1. Footnotes appear at end of article.

new opportunities.⁵

Yet investors, being human, are "social" creatures, preferring herdlike instincts to stand-alone behavior. Most fail to appreciate that change really does occur at the margin. If one can learn to think clearly about the margin, change becomes less surprising, timing improves, and better investment results are sure to follow.

But some words of caution are in order: While good thinking about change at the margin will increase the ability to coordinate what's likely to happen and when it may occur, such connections can rarely be fully anticipated. Therefore, it's better to focus on what's likely to happen, rather than precisely when it will happen. To put it another way, investors must consistently ponder the question, "Does common sense support what is happening at the margin?"

In doing so, they should recognize that "most changes are small," according to Peter H. Burgher:

Nevertheless, you will have to prepare for them as effectively as the big ones for several reasons: (1) the little changes serve as your proof of credibility in preparing for the big ones; (2) an accumulation of small changes poorly prepared for can lead to large problems; and (3) a change which seems trivial to you may appear monumental to others.⁶

Furthermore, from an investor's viewpoint, changes in expectations tend to be magnified in the marketplace.

The point to remember is that change—i.e., a shift in prevailing trends, either as to direction or momentum—should not be regarded as an unexpected phenomenon. Here's how Wanniski explains this crucial concept:

Everyone knows about the straw that broke the camel's back. It is always that 'last straw' that causes a change in the situation, the marginal straw, even though it weighs exactly the same as each of the other 10,000. But it is one thing to see that change occurs on the margin and quite another to understand that each straw is equally to blame for the breaking of the camel's back.

Very few people *think* on the margin, but everyone *acts* on the margin, which is why it is so hard to see that the electorate, as a whole, understands economics.

To get our meaning, consider the camel again. He does not blame the last straw for breaking his back, but all 10,001. If straws could think, though, each of the first 10,000 would not blame themselves for doing in the camel, but would blame the last. The last straw, seeing clearly that his addition caused the camel to break down, would be the only one of the 10,001 to both act and think on the margin. If the straws were replaced by an equivalent weight contained on one log, which had a single mind, that log would both break the camel's back and *understand* that it had caused the event.⁷

Think about price changes in a marketplace, Adam Smith's invisible hand. In essence, if something becomes scarcer, its price rises. As prices rise, demand falls. But supply tends to increase, as producers create substitutes, develop new technologies, or use higher-cost resources. The end result is that, with reduced consumption and increased production, the shortage is alleviated and prices fall. The obverse is also true: As prices fall, demand increases, and producers reduce supply by withholding available resources or shifting activities to areas where the profit potential is greater—at the margin. This is why there are no permanent shortages or permanent oversupplies. One phase of the supply-demand price cycle sets the stage for the rest to follow. Yet most forecasters react to each price cycle as if it were a new economic occurrence, failing to remember either the lessons of history or their economics professors.

Another factor clouding the thought process about change and momentum is the failure to appreciate the concept of countervailing forces. Like the basic laws of physics, where action creates reaction, economic and political trends tend to develop their own countervailing pressures. As Barton Biggs noted, "You must believe that every trend creates a countervailing force that eventually overwhelms it."⁸ Consider

the examples offered by Maurice and Smithson:

In the eighteenth century, Malthus predicted that a food famine was inevitable, given the prevailing trends in production and consumption. This prediction was negated because those trends changed. Specifically, technological progress in agriculture substantially increased the rate of growth of food production. In the twentieth century, many writers predicted a famine in energy and a resultant collapse of the developed economies, again given the prevailing trends in production and consumption. By the 1980s, the forecasted shortage turned into a glut of petroleum. The crisis was averted because the trends changed. As the price of energy rose, consumers used less energy. By and large, this energy saving was the result of technical improvements and the substitution of more energy efficient cars and appliances for the gas guzzlers. Also, as the price of energy rose, producers delivered more energy. Formerly expensive technology for extracting more oil became economically practical at the higher energy prices.⁹

Their conclusion is simple: "Markets work to eliminate shortages; so forecasts of doom or collapse based on shortages are groundless."¹⁰

Thinking About the Market

Despite what theoreticians tell us, investing—particularly at the margin—is not the product of rational and objective analysis, but an emotional response to anxiety—*anxiety about the future*.¹¹ My colleague Bob Farrell put it this way: "Emotions are simply stronger than reason; people do not change and people make markets." There is still no reason to question Bernard Baruch's observation: "What registers in the stock market fluctuations are not the events themselves but the human reaction to these events, how millions of individual men and women feel these happenings may affect the future."

When investors are optimistic, they tend to want to maximize opportunities and take risks; they express them-

selves by increasing the demand for common stocks. When they are nervous and apprehensive, they tend to become cautious and avoid risk; they affect the supply side of the equation by selling equities. These emotional forces, interacting with each other, create a framework for auction-market dynamics. Strong markets begin and perpetuate themselves when pessimism prevails, prices are down and valuations low. At such times, conventional wisdom calls for price erosion. Bear markets begin when optimism is high, values have already expanded, and expectations for further substantial gains are prevalent.

Schultz describes the market cycle as follows:

A bear market in stocks comes about because the prices get too high in relation to their value. This is caused, in turn, by public enthusiasm that gradually gets excessive, appraising stocks out of proportion to their earnings.

It is the nature of such things to go to extremes in both directions; so when a bull market is rampant it goes too high, just as a bear market goes too low. The excesses are caused in turn by human emotions.¹²

The problem is determining, at any point in time, where we are on the curve. It is obviously difficult to assess accurately exactly what stage an idea, or the stock market as a whole, is passing through, and harder still to have complete confidence that future events will not, in fact, reinforce the recent past. But there is a stage at which someone else's old idea carries excessive risk if it is purchased as our own new thought. The question is one of attitude and probabilities, not precise analysis. We never know for sure at which stage an idea is when we encounter it for the first time.

There is, however, a rhythm to the way things work, and a flow to the news that reflects and reinforces significant trends—a sequence to events. Good news tends to follow good news, up to a point, and vice versa, of course.

Judgments of an idea's durability must be based on one's own attitude toward such matters; calculations of

this nature, to be effective, are a function of probabilities, not precise analysis. Investors must develop a willingness to act on common sense and even instinct, rather than relying upon complete knowledge, when judging trends. Henry Kissinger once remarked that foreign policy is "the need to gear action to the assessment that cannot be proved true when it is made." Investing is often no different. Of course, as George Kennan once cautioned, being too far ahead of your time is indistinguishable from error.

A good rule to follow (first promulgated in 1923, as far as I know) to check if good news is a prelude to further good news is to note the stock's (or market's) behavior after the event becomes widely known. If prices show a tendency to continue to advance, one might then expect a continually higher level. But if the price reacts immediately upon publication of the good news and shows no tendency to sell above the point reached at the time of greatest public enthusiasm, then it may have reached its peak for some time to come.¹³

The same is true for bad news. At some point, prices become impervious to further decline, even when the news continues negative; the last shoe has dropped, so to speak. Dividend cuts and subsequent price action are a good example of this concept.

Stock Price Charts Can Help

John D. Connolly of Dean Witter Reynolds has observed that "investing is the art of exploiting trends. Traders hop on wiggles and hope that they're right a reasonable number of times. But it is the big, broad trends that make the most money. Playing the major trends requires ignoring the wiggles."¹⁴

My comrade of over 35 years, Edward Zinbarg of Prudential, Inc., raises a good question on this point. He asks, "When is a 'wiggle' random noise and when is it a 'change' at the margin?" Unfortunately, there are no hard-and-fast rules, no template by which to view the future.

Stock price movements will often mirror new developments long before it is generally recognized that they have taken place. Signs of change

come in many forms and from many directions. For example, early warning signals calling attention to a possible change may take the form of a new trend in a significant statistical indicator or a shift in the attitude of industry participants close to the point of critical action.

Critical factors are not limited to cyclical considerations nor confined to short-term movements, but include slower-moving basic trend changes, social and environmental developments, as well as internal corporate adjustments such as the adoption of new management techniques, new product introductions, changes in market share.

The ability to recognize that a turn has occurred stems from an understanding of the fundamentals of the situation and not from the gathering of functional information. Critical factors may change over time.

Generally speaking, one is more likely to see a favorable change develop when stocks are out of favor, earnings are depressed, price-earnings relationships are relatively low, expectations are limited, and there is no real general interest in the particular industry or stock area.

Conversely, negative developments tend to occur when expectations are generally high, stock prices are advancing or have advanced rapidly, price-earnings ratios have been inflated and the industry or issue continues to gain new investment acceptance on an accelerated basis. Put another way, the odds seem to favor that high price-earnings stocks suffer from unexpected adverse developments and low price-earnings stocks from favorable surprises.

It is not the low multiple by itself that provides unusual opportunity nor the high evaluations that carry excessive risk. It is, rather, that the level of investment anticipations is low on one side and high on the other. This implies that the impact of the unexpected on stock prices is obviously greater on the up side when the P/E is low and greater on the down side when the P/E is high, because the balance of sentiment expects clearly visible trends to continue. New investment decisions are made, and justifiably so, when

these patterns do not develop.

My own belief is that long-term stock price charts can be particularly helpful in executing such thoughtful portfolio maneuvers.¹⁵ Consider Figure A, a schematic diagram of a typical stock price cycle.

This "hypothetical" diagram begins with a major base (1)—a zone of accumulation that has taken months, if not years, to form. In technical analysis, price movement is relative; the bigger the base, the bigger the eventual upside move (2). The same holds true for the distribution areas (4)—the perennial changing of seasons. The cycle begins once again with another major bottom (1).¹⁶

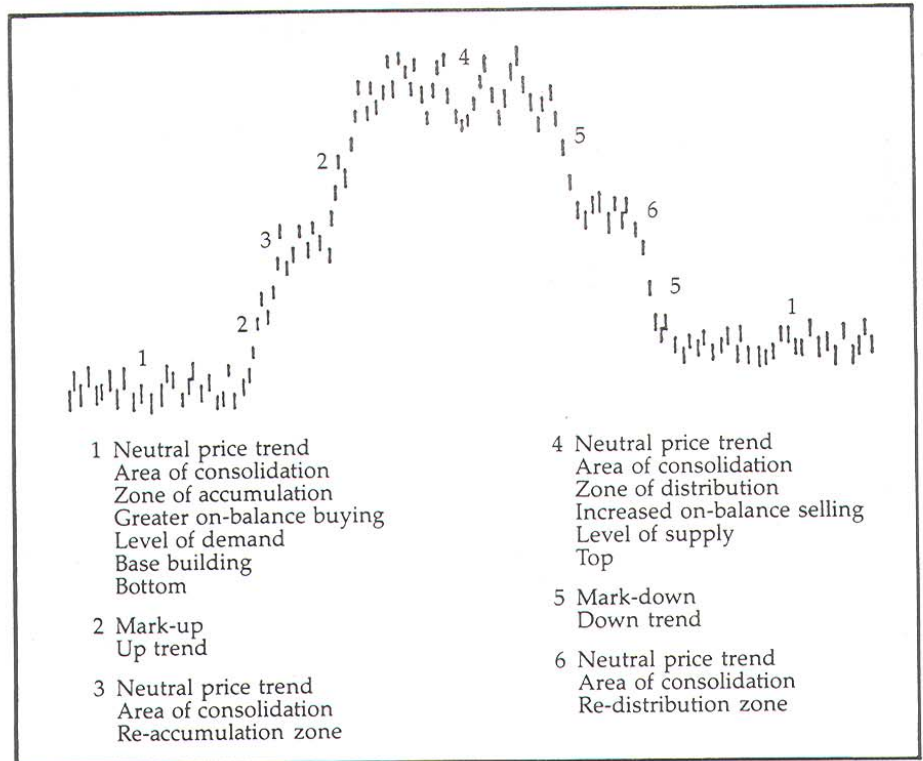
From a practical viewpoint, long-term stock price charts are helpful, if not vital, to gaining insight into how information has already been perceived by the marketplace. They can tell us much about the emotional content of investor confidence, the strength and durability of conventional wisdom and how rapidly it has changed. They vividly portray the build-up and deflation of investor emotions.

In particular, the graphic representation of price movements over time can be considered a proxy for the marketplace's recognition of new developments. It profiles the rate of change in the conventional expectations governing a stock, industry grouping, or even the market as a whole. Perhaps most importantly, price charts provide an indication of the risk involved if prevailing anticipations fail to materialize.

One element deserving focus is the slope of the price curve—the rate of price change. The faster the rate of price change, or the more prolonged the existing trend, the more alert one must become to trend-changing events. To quote Peter Bernstein, "Countervailing forces are always obscure at the beginning."

Two phases of the typical cycle require some further elucidation—the base-building period and the topping-out process. During these two periods, the psychology of stock ownership undergoes significant change. At the top, stock ownership essentially, flows from strong hands to weak ones.

Figure A Schematic Diagram of Stock Price Movements



Source: R. Acampora, "Technical Review and Commentary (T.R.A.C.)" (Kidder, Peabody & Company, Research Department 1, no. 3, February 21, 1984), p. 6.

That is, the successful investor who established a position when expectations were low, values high and pessimism rampant, reaps the rewards of patience and discipline by transferring the ownership risk to a new class of buyers, who hold unrealistic expectations of the future, are overpaying for a trend already well established and will most likely be disappointed. If this happens, the cycle repeats itself once again. In other words, the disappointed late-cycle owners transfer their disappointment to those having more moderate expectations. This process also highlights why, according to Fred C. Kelly, writing in 1930, "Vanity, one's own personal vanity, is probably the greatest single enemy to stock market success. It is vanity that leads us to take small profits but large losses."¹⁷ More recently, Shefrin and Statman put it this way:

The quest for pride, and the avoidance of regret lead to a disposition to realize gains and defer losses. Yet as Kahneman, Tversky, and Thaler all

argue, an asymmetry between the strength of pride and regret (regret is stronger) leads inaction to be favored over action. Consequently, investors who are prone to this bias may be reluctant to realize both gains and losses.¹⁸

Market Efficiency

Before ending, let's think, albeit briefly, about the question of market efficiency. The general concept, anomalies aside, states that securities in the marketplace reflect what is generally known, or likely to be known, so that the market mechanism equates price and value at any point in time. Value-changing efforts are expected to arrive in random fashion so that they cannot be predicted with any degree of accuracy or consistency. From my vantage point, this is not so. One should think about market efficiency in a different fashion, as follows.

- (1) The market is efficient in that current price generally reflects the consensus view of investor

expectations, for the market as a whole and for most individual issues.

- (2) But the consensus view is usually wrong because it's based on a more-or-less simple extrapolation of past trends and events and does not effectively incorporate change into expectations.
- (3) Theory tells us that value-changing events occur in a random fashion and cannot be predicted with any accuracy or consistency.
- (4) This is not so. There is a flow to the news because there is a flow to the events that make the news.
- (5) Stock prices begin reflecting new developments before it is generally recognized that these developments have taken place. As the circle of recognition that a change has taken place widens, a new perception of the future replaces the old, setting the stage for another new change.
- (6) And so it goes.

As a final thought, remember the wisdom of Mark Twain: "It's not best that we should all think alike; it's difference of opinion which makes horse races."

Footnotes

1. The term "sport" is not used lightly, as its common definition means "an active pastime having a set form and body of rules; frequently a competitive endeavor.
2. G. C. Seldon, *Psychology of the Stock Market* (New York: Ticker Publishing Company, 1912), p. 45.
3. J. Wanniski, *The Way The World Works* (New York: Basic Books, 1978), p. 43.
4. D. A. Stoken, *Cycles* (New York: McGraw-Hill Book Company, 1978), p. 51.
5. Source not known, but true.
6. P. H. Burgher, *Changement* (Lexington, MA: Lexington Books, 1979), p. 53.
7. Wanniski, *The Way the World Works*, *op. cit.*, p. 42.
8. B. M. Biggs, "The Historical Case For Still Being Heavy In Stocks," in *Strategy and Economics* (Morgan Stanley, June 23, 1987), p. 1.
9. C. Maurice and C. W. Smithson, *The*

Doomsday Myth, 10,000 Years of Economic Crises (Stanford: Hoover Institution Press, 1984).

10. *Ibid.*
11. Professor Robert J. Shiller of Yale University considers investing in speculative assets a "social activity." See his "Stock Prices and Social Dynamics," *Brookings Papers on Economic Activity*, 2:1984, p. 457.
12. H. D. Schultz, *Bear Markets: How To Survive And Make Money In Them* (Englewood Cliffs, NJ: Prentice-Hall, Inc., 1964), p. 32.
13. See F. C. Kelly and S. Burgess, *How Shrewd Speculators Win, A Guide to Behavior When the Market Rises* (New York: Sears Publishing Company, 1932), p. 71. See also J. L. Fraser, "It Pays To Be Contrary," *Market Technicians Journal*, November 1986, p. 9.
14. J. D. Connolly, "Trends, Wiggles, and Interludes," *The Analysts Commentary* (Dean Witter Reynolds, May 7, 1985).
15. Some observers have actually traced the origins of technical analysis back to 17th century Japan, where, folklore has it, merchants kept charts of the price movements of rice in an attempt to predict the future direction of prices.
16. Ray DeVoe, the iconoclast of Wall Street, breaks a bull market cycle into six stages—(1) aftershock and rebuilding, (2) guarded optimism, (3) enthusiasm, (4) exuberance, (5) unreality and (6) cold water and disillusionment. See "What's a Bull Market, Dad?" *Across the Board*, August 1978, p. 4.
17. F. C. Kelly, *The Psychology of Speculation, Why You Win or Lose* (Burlington, VT: Fraser Publishing Company, 1981), p. 34.
18. H. Shefrin and M. Statman, "The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence," *Journal of Finance*, July 1985.

*We are pleased to announce
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